Supreme Court, U.S.
FILED
JUN 25 1997
CLERK

(3)

No. 96-1770

In The

Supreme Court of the United States

October Term, 1996

ROBERT C. MILLER, CHARLES BOESENBERG, DAVID G. LUDVIGSON, and MIPS COMPUTER SYSTEMS, INC.,

Petitioners,

v.

DIANE PROVENZ and AHIKIM EIZENBERG, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

Petition For Writ Of Certirorai To The United States Court Of Appeals For The Ninth Circuit

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14 pp

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INTRODUCTION

This case presents an extreme illustration of the confluence of two recurring issues that are critical to private securities class actions under Section 10(b). The first issue is whether recklessness is sufficient to satisfy the scienter requirement of the statute and, if so, whether at least subjective recklessness akin to actual intent is required under *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). The second issue is whether a plaintiff in an accounting case under Section 10(b) can create a triable issue of scienter under any formulation where the evidence is uncontroverted that the company and its auditors genuinely believed that the accounting complied with GAAP and all of the challenged revenue was collected. This case presents the perfect vehicle for the Court to resolve these issues because application of at least a subjective recklessness standard would compel reversal of Judge Pregerson's opinion for the Ninth Circuit, and reinstatement of the district court's original grant of summary judgment.

Plaintiffs make four arguments why certiorari should not be granted. For the reasons set forth below, none of these arguments provides grounds for denying certiorari on the questions presented.

I. The Pressing Question of What Constitutes "Scienter" under Section 10(b) of the Securities Exchange Act of 1934 In An Accounting Fraud Case Is Directly Presented by this Case.

Plaintiffs claim that it is "nonsense" to assert that there is disarray among the lower courts on the scienter issue, because all Circuits "uniformly" apply some form of a recklessness test. Opp. 1. Whether that test is an objective test or a subjective test makes no difference, according to plaintiffs, because subjective knowledge – bad faith – may be inferred from objective facts:

> Any distinction between "objective" and "subjective" recklessness is inconsequential at the summary judgment stage, in any event. If the evidence shows that defendants were "objectively" reckless, how can they argue that a jury may not determine that they were in fact "subjectively" reckless?

Opp. at 12. Plaintiffs argue for what is in essence the approach taken by the Ninth Circuit: it assumed that any evidence of recklessness suffices under *Hochfelder*. Only because plaintiffs attempt to blur the distinction between subjective and objective recklessness do they see no disarray among the Circuits, or incongruity between the Ninth Circuit's approach and *Hochfelder*.

The crucial issue is whether any mental state short of *actual intent* is permissible under the statutory language of Section 10(b) and *Hochfelder*. Plaintiffs do not even discuss *Hochfelder*'s analysis of Section 10(b). It is enough for plaintiffs that the Court reserved the question whether "in some circumstances" recklessness might suffice. 425 U.S. at 194 n.12. But the objective recklessness standard plaintiffs espouse is inconsistent with *Hochfelder*'s analysis of the statutory language of Section 10(b).

In *Hochfelder*, the Court stated that the language of Section 10(b) "so clearly connotes intentional misconduct" that "further inquiry may be unnecessary." *Id.* at 201. The Court concluded that the statute's words plainly gave "no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith." *Id.* at 206. In reserving the question whether "in some circumstances" recklessness might satisfy this standard, the Court referred to the type of recklessness that, under the common law of fraud, was "considered to be a form of intentional conduct." *Id.* at

194 n.12. The Petition demonstrated that those "circumstances" were limited to *subjective* recklessness: the common law required dishonesty – bad faith – not merely objectively unreasonable conduct. Pet. 16-20; Opp. 7 & n.2 (quoting *Lehigh Zinc & Iron Co. v. Bamford*, 150 U.S. 665, 672 (1893) (person must have been "conscious that he has no such knowledge")).[1]

This Court repeatedly has recognized the crucial distinction between objective and subjective state of mind tests. It was the basis for the Court's analysis of the "deliberate indifference" requirement under 42 U.S.C. § 1983, which requires "conscious" disregard and focuses "on what a defendant's mental attitude actually was (or is) [subjective], rather than what it should have been (or should be) [objective]." *Farmer v. Brennan*, 511 U.S. 825, 838-40 (1994). Likewise, it is the basis for the Court's analysis of the mental state necessary to show "actual malice" in public figure defamation cases. *Harte-Hanks Communications, Inc. v. Connaughton*, 491 U.S. 657, 689 (1989). Indeed, in arguing that recklessness should be sufficient under Section 10(b), all of plaintiffs' authority speak of the *actual* state of mind of the defendant – a *subjective* recklessness standard.[2]

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[1] As the seminal decision on deceit law observed more than a century ago, plaintiffs have "confus[ed] [] unreasonableness of belief as evidence of dishonesty, and unreasonableness of belief as of itself a ground of action." *Derry v. Peek*, 14 App. Cas. 337, 352 (H.L. 1889).

[2] Opp. 7-8 & n.3. *See Cooper v. Schlesinger*, 111 U.S. 148, 155 (1884) ("a statement recklessly made, without knowledge of its truth, was a false statement knowingly made."); *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931) (Cardozo, J.) ("the pretense of knowledge when knowledge there is none."); *see also* W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, *Prosser and Keeton on Torts* § 107, at 741-42 (5th ed. 1984) ("intent to mislead . . . is present when the representation is made without any belief as to its truth. . . . ").

In denying that there is any confusion among the Circuits, plaintiffs stand alone. Commentators repeatedly have described the caselaw as "largely incoherent,"[3] "too amorphous,"[4] "highly indeterminate,"[5] "deeply" split,[6] and "a veritable quagmire for the courts."[7] As one commentator summarized, "resolution of the availability of a recklessness standard, as well as a more explicit definition, must await Supreme Court determination."[8]

Nowhere is the need for this Court's guidance more apparent than in the Ninth Circuit. In *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991), while the Ninth Circuit recited the standard of *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977), it incongruously made clear that it was *not* adopting a subjective standard by *rejecting* the subjective standard proposed by the SEC. 914 F.2d at 1569 n.7.

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[3] Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. Cin. L. Rev. 667, 686 (1991).

[4] 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 84 (2d ed. 1990).

[5] James D. Cox, et al., *Securities Regulation: Cases and Materials* 740 (1991).

[6] Marc I. Steinberg & Samuel H. Gruenbaum, *Variations of "Recklessness" After Hochfelder and Aaron*, 8 Sec. Reg. L. J. 179, 181 (1980).

[7] Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986).

[8] 2 Hazen, *supra* note 4, at 84.

II. A Mere Difference of Accounting Opinion Cannot Create a Triable Issue of Scienter.

Because plaintiffs view the distinction between subjective and objective recklessness as a debater's point, they contend that the Petition should be denied because the evidence is sufficient to create a triable issue of "recklessness," and the Court should not waste its time reviewing the evidence. Opp. 13. By ignoring this crucial distinction, plaintiffs fail to address the critical issue: application of a subjective standard in this case would be dispositive because there was no evidence creating a triable issue of bad faith. The Ninth Circuit's application of an objective standard allowed plaintiffs' accounting experts to create a triable issue by second-guessing accounting decisions years after MIPS and its auditors made those decisions in good faith.

The evidence that plaintiffs purport to marshall in support of the Ninth Circuit's decision could not sustain a triable issue of bad faith. Plaintiffs rely on the opinions of their accounting experts and their own selective interpretations of snippets of documents and testimony. For example, according to plaintiffs, the central accounting question was whether MIPS violated the "undisputed general rule" that revenue had to be earned before it was recognized because MIPS recognized revenue before shipping all contract deliverables. Opp. 4-5. Not only did the accounting literature cited by plaintiffs' experts demonstrate that, far from a clear standard, there was a range of permissible accounting treatments for technology licensing agreements, there was *no* evidence to rebut defendants' (and their auditors') good faith belief that MIPS' accounting was within that permissible range. Pet. 4-6, 27-28.

Plaintiffs contend that a triable issue of bad faith exists from the fact that defendants violated the accounting policy disclosed in MIPS' Form 10-K and its internal

policies. Opp. 5. Not only does this ignore the express language of the policy, which states that revenue recognition is "dependent upon the nature and level of efforts required to deliver and or support the technology transfer," it ignores unrebutted testimony that MIPS and its auditors believed they were complying with the policy by applying their judgment to the varying circumstances of each transaction. Pet. 6-7, 29-30.

Plaintiffs quibble that a triable issue of bad faith exists because MIPS did not show its auditors every piece of paper generated during the negotiation of each transaction. Opp. 5. Auditors never see every objective fact concerning a transaction and its negotiation. The crucial point is that the auditors understood and approved of MIPS' accounting judgments as to each of the specific revenue recognition issues.[9] That MIPS voluntarily consulted with the auditors in every quarter, that their judgments were proven correct, and that MIPS collected all of the supposedly unearned revenue dispels any inference of bad faith. Pet. 6

Plaintiffs' proffered evidence concerning the non-accounting claims would not even meet an objective recklessness test. With respect to the second quarter forecast, plaintiffs go mute when faced with the full testimony of the witness both they and the Ninth Circuit relied upon, who testified that the spreadsheet at issue was only a superseded preliminary draft of the quarterly forecast.

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[9] Plaintiffs had no evidence refuting MIPS' showing that the transfer of the remaining deliverables was a virtually costless, immaterial act that did not preclude revenue recognition (Pet. 4-5; 29-30); no evidence showing that MIPS and its auditors believed that Japanese and Korean government approval was anything but a ministerial act (Pet. 6-7); and no evidence undercutting MIPS' and its auditors' belief that purchase orders signed by a senior executive of NEC were binding agreements (Pet. 7).

Pet. 7, 27 n.17. With respect to the R6000 product, plaintiffs and the Ninth Circuit recited the product's problems but ignored the fact that defendants had *disclosed* those problems, such as severe supply constraints and the need to find a second- source supplier. Pet. 7.[10] Moreover, as to these issues, the Ninth Circuit's reliance on snippets of circumstantial evidence ran afoul of *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586-87, 597 n.21 (1986) (courts must examine "the record taken as a whole").

III. The Court Need Not Await a Case under the Private Securities Litigation Reform Act to Answer the Question Reserved in *Hochfelder*.

Plaintiffs argue that addressing the recklessness question left open in *Hochfelder* is premature, because the Court should wait several years for a case subject to the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. N. 104-67, 109 Stat. 737. Opp. 15-16. Plaintiffs' position has no merit. This case provides the perfect vehicle to answer *Hochfelder*'s open question because the Court could provide much needed guidance relevant to both pre- and post-PSLRA cases.

Were the Court to await a PSLRA case involving accounting fraud claims, the Court would likely have to answer the question squarely presented here, the

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[10] See ER 172/139:6, 12-13; ER 172/134:15, 26-27; ER 172/142:7-8. There can be no dispute that the market heard these dire warnings. Prominent analysts questioned whether large customers would order the product (SR 201/146:1); reported that microprocessor yields had been low and "reengineering work has been required" (ER 131/102:89945); reported a "high level of retrofit/spares" and "below-target reliability" (SR 201/155:4); and cautioned that the R6000's "window of opportunity is closing rapidly" (SR 201/159).

reserved question in *Hochfelder*: "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b). . . . " 425 U.S. at 194 n.12. Plaintiffs contend that the Court should wait because some courts have held that the PSLRA "changed" the scienter standard under Section 10(b) for cases involving alleged misstatements of historical fact, such as accounting cases. Opp. 15-16 & n.18. The cases plaintiffs cite, however, held that Congress intended in the PSLRA to return to the standard announced in *Hochfelder* by stripping away the objective recklessness gloss being applied in the Courts of Appeals. Consistent with *Hochfelder*, these courts have held that scienter requires a showing of "knowing or intentional misconduct," which includes only "deliberate" or subjective recklessness.[11] Thus, there is no reason to wait for a case under the PSLRA because the Court would still need to answer *Hochfelder*'s reserved question.

In any event, dozens and dozens of securities class actions were pending when the PSLRA became effective. Many of these cases involve allegations of accounting fraud, and likely involve billions of dollars in potential damages from high technology companies and their individual officers and directors, as well as from the insurance companies that underwrite directors' and officers' insurance. It will take years for the right case subject to the PSLRA even to reach this Court. Delay in resolving

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[11] *In re Silicon Graphics Sec. Litig.*, No. C 96-0393 FMS, 1997 U.S. Dist. LEXIS 7551, at *29 (N.D. Cal. May 23, 1997). *See Norwood Venture Corp. v. Converse, Inc.*, 959 F. Supp. 205, 1997 U.S. Dist. LEXIS 4292, at *7-9 (S.D.N.Y. Apr. 9, 1997) ("the scienter requirement requires a plaintiff to allege 'circumstances indicating conscious behavior by defendants.' ") (citation omitted); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 1997 U.S. Dist. LEXIS 2893, at *19-20, 25, 27 (D. Mass. Mar. 7, 1997) ("plaintiff must set forth specific facts that constitute strong circumstantial evidence of conscious behavior by defendants").

the scienter issue will allow the unpredictability and confusion among the lower courts to multiply as they struggle to divine some consistent standard. *See Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 188 (1994) (Section 10(b) litigation "demands certainty and predictability") (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

IV. The Recklessness Question Is Properly Before The Court

Finally, plaintiffs object that defendants did not preserve the question of whether recklessness is sufficient under Section 10(b). Opp. at 8-9. Plaintiffs' position is not valid. Throughout the entire case defendants have maintained that plaintiffs had no evidence creating a triable issue of intentional fraud or bad faith. Defendants expressly argued that mere differences of accounting opinion cannot create a triable issue of scienter, urging the Ninth Circuit to follow the Court's decision in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 544 (1979), and argued that even unreasonable accounting cannot create a triable issue of scienter. Appellees' Answering Brief 7-8, 11, 13. In seeking rehearing of the panel's original and amended decisions, defendants reasserted these arguments. First Petition for Rehearing 9-10; Second Petition for Rehearing 8-9. Thus, the question of whether evidence of mere objective recklessness is sufficient under Section 10(b) was squarely before the Ninth Circuit.[12]

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[12] The Ninth Circuit addressed the scienter question *en banc* in *Hollinger*, holding that recklessness was sufficient to impose liability under Section 10(b). 914 F.2d at 1568-69. Because the panel was obliged to follow this *en banc* holding, defendants did not challenge at the panel level whether actual intent is required by the statute.

Policy considerations strongly support accepting review of this question. In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099 n.8 (1991), the Court decided to consider an (allegedly unasserted) issue because it was "in a state of evolving definition and uncertainty, [citations omitted] and one of importance to the administration of federal law." *Cf. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S 164 (1994) (resolving unasserted question of aiding and abetting liability after directing parties to address issue). The great uncertainty that pervades the scienter standard, combined with the unique danger of vexatiousness posed by private actions under Section 10(b), which this Court has long recognized, and the significance of accounting issues, support granting the Petition to resolve this issue of overriding importance.

CONCLUSION

For all of these reasons, certiorari should be granted.

Respectfully submitted,

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June 24, 1997